HUNTON& WILLIAMS

Fifth Annual Energy Regulatory Conference for Central/Eastern Europe & Eurasia

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December 4, 2001
Sofia, Bulgaria

Role of the Regulator in the Privatization Process

Overview

- I. What Role Should the Regulator Play in Privatization of Energy Sector Assets?
- II. History of Recent Privatization of Distribution Companies in Ukraine
- III. How Well Did NERC Perform its Role?
- IV. What Are the Lessons to be Learned?

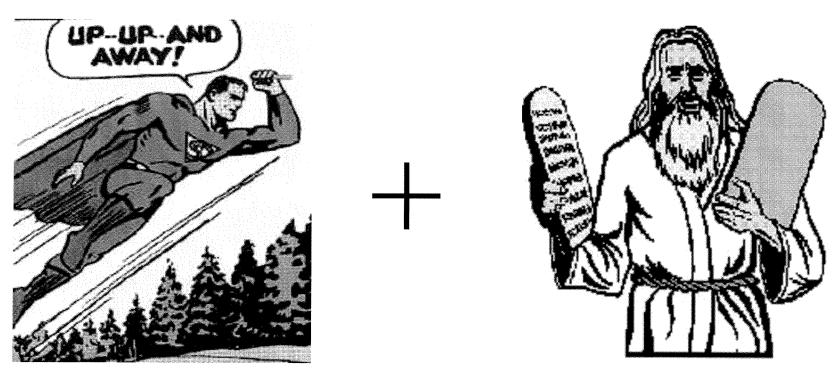
I. What Role Should the Regulator Play in Privatization of Energy Sector Assets?

The Regulator's role in a privatization is like that of a referee at a soccer match--to manage the expectations of all the competing interests without compromising its autonomy



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Q. Who would be the ideal regulator in a privatization?



A. A combination of Superman and Moses

Generally, the Regulator's participation in a privation includes:

- Providing input to the Government on its privatization strategy and energy policy
- Providing information to the Investment Bank and other financial advisors to the Government
- Participating in preparation of tender documents
- Meeting with potential bidders

And

· Demonstrating its Skills as a Regulator

The Regulator's most important role in a privatization is to provide potential strategic investors with regulatory reassurance in three areas:

- Tariff
- Process
- Licenses

What the Regulator Should <u>Not</u> Do in a Privatization

- Participate in evaluation of bids or selection of winner
- Negotiate with bidders after short list is drawn up but before a winner has been selected
- Permit substantive changes to licenses during period between short-listing and selection

II. History of Recent Privatization of Distribution Companies in Ukraine

April 2001- AES submitted the winning bid for Kievoblenergo and Rivneoblenergo; Vychodoslovenke Energetizke Zovody S.P. (VEZ) won Khersonoblenergo, Sevastopoloblenergo, Zhitomiroblenergo and Kirovogradoblenergo; total revenues from sales: \$160 million

May 2001- PSAs executed

Was the Privatization a Success?

Yes

- All six oblenergos sold at an average purchase price of 55.8% over the minimum bid price
- The nominal purchasers were strategic investors
- The sale was conducted in a transparent manner consistent with international standards

Was the Privatization a Success?

No

- The GOU did not adequately address all of strategic investors' concerns with the result that out of seven original short-listed bidders, only three actually bid
- One of the winning "strategic" investors was a "front" for non-qualifying investors due to loosely-worded tender regulations by the State Property Fund

III. How Well Did NERC Perform its Role?

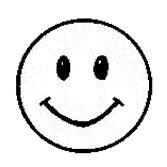


What NERC Did Right:

Meeting investor expectations as regards the tariff methodology

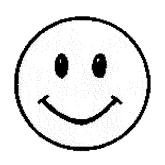
• Balancing consumer interests with investor interests

• Transparent Procedure



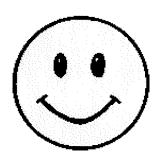
Meeting Investor Expectations:

- rate of return on rate base set at 17% after taxes for first 7 years and not less than 11% for next 5 years
- technical losses for first 5 years to be based on losses incurred in year preceding privatization
- Formula allowance for commercial losses capped at 7% for first 3 years, 4% for next 2 years, 3% for next 2 years



Balancing of Interests:

- Acquisition rate base limited to 1.5x minimum bid price
- Exit from the "transit account" allowed after 3 months of 100% cash payment for all electricity purchased and execution of debt repayment schedule with Energomarket
- No limit on new investment rate base



Transparent Procedure:

- Public notice of proposed methodology
- Participation of all interested parties invited
- Timely consideration of issues and publication of decisions approving tariff increases
- Maintained appearance of independence in development of tariff methodology



What Regulatory Issues Could Have Been Handled Better?

The Algorithm: Frequent changes to the "algorithm" contributed to perceived regulatory risk

Funds were reallocated over 30 times in the 12 months ending October 31, 2001 based on claimed emergencies and other reasons

Disconnection Policy: NERC's resolution on disconnection of non-paying customers is unclear

Tariff Implementation: Post-privatization, tariffs were not raised in a timely manner to allow recovery of purchase costs

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Main Reason for Problems?

- NERC still has not gained independence from CabMin.
- Draft NERC law which would have increased its independence failed to pass the Verkhovna Rada on November 15, 2001 because of a procedural deficiency

IV. What are the Lessons to be Learned?

- A sound tariff methodology with a reasonable rate of return will go a long way to facilitating privatization of electric distribution compares
- But without regulatory independence, political will and a predictable legal/regulatory environment, it will not be enough